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TIME TO REVIEW THE BUY-SELL AGREEMENT

The owners of many closely-held businesses have provided by written agreement for the transfer of shares in those businesses upon the death, disability or retirement of one or more of the owners. Sometimes called "buy-sell agreements," "stock purchase agreements" or "redemption agreements," these documents usually restrict the lifetime transfer of shares in the business and set the price at which an interest can be purchased by the remaining owners. Many such businesses now require a buy-sell agreement "check-up."

For many years, the "entity purchase" form of agreement was very popular. The corporation is the primary purchaser of shares in an entity purchase agreement. One reason for its popularity is that the corporation directly pays for the life insurance used to fund the post-mortem purchase of stock. The disparity between corporate and individual tax rates was just one reason why business owners often preferred to leave that premium payment obligation with the corporation rather than assume it personally.

In 1986 the life insurance proceeds used to fund buy-sell agreements became subject to the corporate alternative minimum tax ("AMT").

The AMT calculation begins with 75% of the excess of adjusted current earnings over alternative minimum taxable income ("AMTI") without the life insurance. IRC sec. 56(g)(1). Life insurance proceeds are included in adjusted current earnings ("ACE") according to Revenue Ruling 54-230, 1954-1 CB 114, and Regulations §1.56(g)-1(c)(5)(v).

How do these rules work? Their effect can be isolated by looking at a simple case involving a corporation with no other "tax preferences" and no other income subject to regular tax. Although a personal service corporation might be the most likely company to fit this profile, mercantile or manufacturing enterprises can be in the same position.

In 2007, a shareholder of the company died, and the company received $500,000 of insurance as a result. The first step in estimating the alternative minimum tax on this company is to reduce the insurance proceeds by 25%. Only 75% of the excess of ACE over "regular" AMTI is a preference item. The resulting $375,000 (500,000 x .75) is taxed at the 20% alternative minimum tax rate. The corporation will pay a $75,000 tax (375,000 x .20) for the "privilege" of being the recipient of life insurance proceeds.

The example chosen for illustrative purposes deliberately "pegged" ACE at more than $310,000. There is a statutory exemption for the first $40,000 of AMTI, but it is phased out at

AMTI between $150,000 and $310,000. If 75% of the insurance proceeds were less than $310,000, calculating the actual tax would require determining what exemption was available under section 55(d).

The business owner can estimate the possible alternative minimum tax cost of having the business receive insurance proceeds used to fund a post-mortem corporate redemption. Assuming the company is profitable in the year when the proceeds are received, the alternative minimum tax could be 15% (.20 x .75) of the proceeds. The potential of reducing the available insurance fund by 15% could lead the business owner to seek alternatives. Fortunately, creative alternatives exist.

- S corporations do not pay the alternative minimum tax, and they are attractive for other reasons. Companies which have not yet done the S corporation/C corporation "drill" should do so -- or do it <u>again</u> if they have remained C corporations and executed an entity purchase buy-sell agreement.

- The cross purchase form of buy-sell agreement avoids the AMTI problem. This approach to buy-sell planning requires each of the shareholders to purchase shares -- rather than the corporation purchasing shares -- upon the occurrence of one of the "triggering" events. The insurance is owned by the individual shareholders, and so insurance proceeds have no impact on the corporate income statement. Another advantage to the remaining shareholder is the addition to that shareholder's basis in the stock of the company. No such "step-up" occurs when the insurance goes directly to the corporation for the redemption of shares.

- A separate partnership might be created solely to own the life insurance. The partners are the same people as the shareholders of the corporation. The partnership acts as a bank to finance the obligations of the parties to the stock purchase agreement. This technique has only tentative IRS approval and should, therefore, be used cautiously.

- New or additional insurance can be purchased. If all shareholders are still insurable at acceptable rates, two insurance possibilities might be considered. First, existing policies might be surrendered and new policies acquired to fund a cross-purchase agreement. New policies are necessary because of the difficulty of overcoming the "transfer-for-value" rule if the existing policies were simply transferred out to the shareholders and then used to fund the new cross-purchase agreement. The transfer-for-value rule converts what would have been income tax-free proceeds into taxable proceeds.

A second planning option might appeal to companies with many shareholders because it avoids the multiplicity of policies required to fund a cross-purchase agreement. This option is simply to insure at the corporate level against the alternative minimum tax. Careful financial modeling is necessary to estimate the tax increase. In very few actual cases is the increase an "automatic" 15% of the insurance proceeds. Such items as AMTI credits against regular tax and net operating losses must be taken into account in constructing the model.

An additional reason for <u>all</u> corporations -- both C and S -- to consider a timely buy-sell "checkup" is the recent emphasis of the Internal Revenue Service on achieving <u>actual</u> fair market value through the use of whatever price formula is found in the buy-sell agreement. "Aggressive" valuation tactics are no longer appropriate in the buy-sell agreement.

Accordingly, the recommended review will focus on at least three questions: Who is the purchaser? What is the source of funding? What is the price? Additional questions unique to each particular situation will also come to light during the review.

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